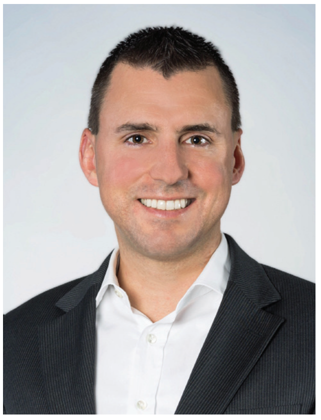
KEYNOTE INTERVIEW

Applying a thematic lens to secondaries



Proactively tracking assets across global themes can provide an early edge in continuation fund opportunities, say Partners Group's Anthony Shontz and Roy Baumann

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Q What is the outlook for LP and GP-led dealflow?

Anthony Shontz: Continuation vehicle technology is constantly evolving, and it has become the growth engine of the secondaries market.

That said, it is important to remember that LP portfolios accounted for just over half of overall secondaries volume in 2022 and remain an attractive part of the market. Activity is surging. Institutional investors are scrambling to rebalance portfolios as a result of the denominator effect and seeking liquidity to continue supporting core GPs. The LP portfolio space is growing and the returns we have seen there are on par with what concentrated extension secondaries are delivering.

In the continuation fund space, LPs have strong appetite for liquidity. Prior to 2022 you would see around 50-60 percent of LPs taking the rollover option, with a minority exiting.

That has flipped, and you now regularly see 80-85 percent of investors taking the cash.

Roy Baumann: A number of continuation funds were launched last year but then pulled because valuations didn't meet GP and investor expectations. Some of the most attractive assets did close, so the market is still open for the right opportunities, but creating a win-win situation has become harder.

GPs are generally opportunistic, so they will not go ahead with an extension secondary if the discount is too high. For an LP portfolio, however, the transaction is driven by the need for liquidity. LPs often need to sell, and the discount is just the cost of early liquidity. In a continuation fund scenario, meanwhile, a GP is less likely to bring forward an opportunity to LPs at a price significantly below the net asset value.

Q How are you filtering opportunities and splitting your allocation between GP-led and LP portfolio deals?

AS: At Partners Group, we are a big believer in relative value. It is a core part of our investment philosophy. We don't have a US fund, or an Asian fund or a European fund. We look at and compare US versus Asia versus Europe to find the best opportunities at any given time. We do the same when we are comparing LP portfolios and continuation funds, and at the moment we are seeing the relative value shift towards LP portfolios given the pricing dynamic.

There is an average 15-20 percent discount for diversified LP portfolios comprised of good assets. LPs are selling what they can right now, and the only transactions that are trading involve the best funds and the best GPs. These assets are trading at discounts. That presents attractive relative value.

Q How thematic is your approach to GP-led deals?

AS: We are very thematic. We have industry experts in different verticals on the team and we are often tracking assets for months before any kind of transaction is even on the table.

When a GP is ready to sell an asset, we tailor the transaction to what they are looking for. We often start the dialogue with the GP not knowing where we will end up. We can become a control investor, we can do a minority recap and let the GP stay in control, or we can move the asset into a continuation fund.

These discussions often take place before an intermediary is hired to run an auction or raise a continuation fund. We lean heavily into situations where

Q How are you approaching GP-led transactions, and how hands-on are you in terms of the underlying assets?

AS: There are two ways to make money in secondaries. You can buy mediocre assets at a price low enough where the discount drives the return, or you can buy great assets that are increasing in value. Our focus as a firm is on the latter.

We often talk about buying at the inflection point, where, from a price perspective, we are buying into value creation. If we are investing in a continuation fund, we want to make sure we are at that inflection point, and that there is a transformational plan in place that will take the asset to the next level.

When we're a lead control investor, we drive that. In a continuation fund the focus is on ensuring the right GP and the right management team are in place upfront, and that the asset is truly exceptional. We typically don't influence or insert ourselves in the governance. It's a little bit different compared to a control buyout.

Of course, if there's a particular company or industry where we are well-connected and have expertise, we may take a board seat or a board observer seat to lend our perspective and insights. But generally, we're investing in very capable GPs that we trust.

RB: In multi-asset continuation funds it is important to look at the composition of a portfolio and we do take an active role in shaping how assets are bundled together. In the past, GPs could just wrap up what's left in a tail-end fund and put everything into a continuation fund. In the current market that kind of package would be quite difficult to sell. Investors have clearly become more selective.

we've been tracking an asset and will tailor the investment structure in a way that best suits the vendor and the business.

Q How common is a thematic approach in the GP-led market?

RB: I can't think of any other firm where the secondaries team collaborates so closely with a direct investing team.

Some of our peers have research teams within banks, other firms may have buyout teams in separate divisions of related entities. Partners Group is truly integrated, and there's always been a culture of close collaboration across the whole firm. That is hugely valuable.

The firm has an ownership mindset and that translates into what we do in secondaries. Traditionally, secondaries have been opportunistic, somewhat limited by what's for sale. We are not just waiting to see what comes to market. We like to identify specific assets that fit our investment themes, and then proactively pursue discussions with GPs that own the target assets. This allows us to be selective.

> *"If you think about investing capital consistently and efficiently, having a broader spectrum gives you more flexibility"*
>
> **ROY BAUMANN**

Q Are you seeing a move towards greater specialisation in the market, particularly given the rise of dedicated GP-led funds?

AS: Secondaries GPs are increasingly offering their LPs the option to choose between a diversified LP portfolio strategy or a concentrated continuation fund secondaries strategy.

If you look at the private equity industry more generally, we have seen how GPs have become more specialised and the range of options has proliferated. LPs can choose levered exposure or unlevered exposure, and fund managers have become more sophisticated in how they utilise credit lines at the fund level. The optionality trend has also been observed in the secondaries market. The rise of dedicated funds for LP portfolios and extension secondaries is the next iteration of this evolution.

There are, of course, pros and cons to adopting a focused fund strategy. Continuation funds tend to give exposure to higher quality assets as GPs are using these vehicles to continue compounding returns in their premier companies. However, a fund dedicated to the extension secondary strategy comes with greater concentration risk and higher pricing, and you don't capture the discount that you get with diversified LP portfolios.

There is currently a lot of debate about this. Everybody raising a fund is asking themselves what the structure should look like. I think that conversation will continue, and ultimately LPs will be given more choices in how they tailor their secondaries market exposure.

RB: If you think about investing capital consistently and efficiently, having a broader spectrum gives you more flexibility. If you are a manager focused only on continuation funds, 2023 is going to be a tough year because there are fewer opportunities around. As we mentioned earlier, you also miss out on the attractive relative value on offer in the LP-portfolio market.

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>
> **ANTHONY SHONTZ**

The counterargument is that there is merit in the experience that comes through specialisation. If you have a small team, it may make sense to focus. At Partners Group, we have a big team and a powerful platform, which provides the network and expertise to be a leader in both segments of the market. We believe there is real value in having this flexibility. ■

Anthony Shontz is a partner and head of private equity partnership investments at Partners Group, and Roy Baumann is a managing director for private equity partnership investments at the firm